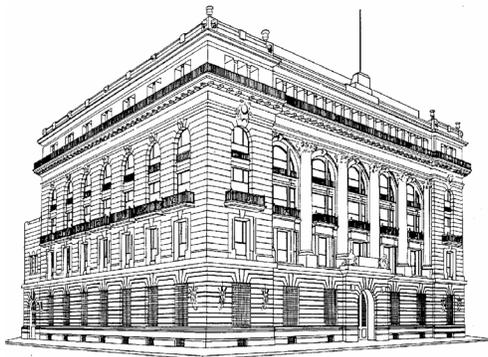


# Annual Report Summary

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2005



BANCO DE MEXICO

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APRIL 2006



## I. Introduction

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The world economy exhibited a favorable performance during 2005. The strength of world economic growth, particularly of some Asian economies that make intensive use of energy goods in their productive processes, together with restrictions to increase the supply of these products, led to a significant increase in energy prices. The hurricanes that affected the supply of some energy goods during the second half of the year also contributed to such results.

Favorable conditions prevailed in international financial markets throughout 2005. Under such context, sovereign spreads for some emerging economies recorded historically low levels during the last quarter of 2005. Prevailing conditions in international financial markets, as well as the substantial increase in international prices of several commodities, contributed to the appreciation of assets and currencies in emerging economies.

The Mexican economy grew 3 percent in 2005, figure below that recorded during 2004 (4.2 percent) and lower than that anticipated by analysts at the start of the year. During 2005, just like in the previous year, the performance of domestic expenditure and economic activity benefited from the significant increase in Mexico's oil trade balance surplus and by revenues from workers' remittances.

Headline inflation decreased significantly throughout 2005, reaching 3.33 percent in December. This mainly reflects both the reversion of the supply shocks that affected the economy in 2004 and the effects of the monetary policy actions. The atypical behavior of the prices of certain fruits and vegetables also contributed to the swift reduction of inflation in the last few months of 2005. Core inflation, which is a better indicator of the medium-term trend of headline inflation, fell significantly, reaching an annual variation of 3.12 percent at the end of 2005. These results have contributed to reduce inflation expectations for all terms.

The evident improvement in the inflationary outlook for the Mexican economy and a benign global financial environment created favorable conditions for the Board of Governors of Banco de México to begin to revert its stance of monetary astringency adopted during 2004 and the first half of 2005.

## II. International Environment

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The world economy continued to exhibit vigorous growth during 2005, while inflation remained low despite further increases in oil prices. Economic activity in the U.S. slowed, while economic growth remained strong in Asia due to vigorous expansion in China and to Japan's economic rebound. Despite higher short-term interest rates, emerging economies continued to benefit from very favorable conditions of access to international financial markets. Furthermore, sovereign debt spreads recorded historically low levels.

The dynamism of emerging economies, particularly those in Asia, explains to a large extent the extraordinary strength of world economic growth over the last few years. The vigorous expansion of these economies, which make intensive use of energy and other raw materials, has led to price increases in these goods and, as a result, to an improvement in the terms of trade of countries which export them. Thus, oil prices continued to increase during 2005. Oil prices also reflected the narrow margin of idle capacity, supply disruptions due to natural disasters, and political uncertainty in several oil producing countries. In this context, expectations that energy prices would remain high for a considerable period of time were reaffirmed.

During 2005, the U.S. economy grew 3.5 percent, figure close to what is considered its potential. This result was attained despite new surges in oil prices, higher interest rates and the hurricanes that struck the Gulf of Mexico, which contributed to slower economic growth during the last quarter of the year. The general government's deficit measured as a proportion of GDP declined from 4.7 percent in 2004 to 3.8 percent in 2005. The reduction of the general government's fiscal imbalance was brought about by a surprising increase in revenues (10.9 percent) stemming from strong economic growth. In particular, fiscal revenues were boosted significantly by taxes on corporate profits, which rose 41 percent with respect to 2004 and accounted for 2.9 percent of GDP, their highest level for several decades.

In 2005, the U.S. current account deficit widened by 137 billion dollars as compared with 2004 and accounted for 6.4 percent of GDP, a new historic record. This result responded to strong domestic demand, higher prices on imported oil and a significant decline in the positive balance of factor services (from 30.4 to just 1.6 billion dollars). Although the global economic rebound has fueled solid growth in U.S. exports for two consecutive years, the volume of the country's imports has meant that export growth has been insufficient to reduce the deficit. Nonetheless, the size of the deficit has not particularly affected the exchange rate or interest rates.

The inflationary outlook for the U.S. economy deteriorated during 2005. Increasing energy prices led to upward pressure on headline CPI inflation, which reached 3.4 percent in 2005 -its highest level since 1991. However, core inflation remained at modest levels, below long-term inflation expectations implicit in yields on inflation-indexed and nominal bonds, as well as those obtained from economic analysts' surveys (around 2.5 percent). Annual core CPI inflation was 2.2 percent, while the personal consumption deflator grew 2 percent. Although high energy prices have not affected core inflation, possible inflationary pressures stemming from such prices continue to be a cause for concern. Furthermore, inflationary

risks related to increased resource utilization and moderation of productivity growth have also become more evident.

Financial conditions continued to favor the expansion of demand, despite a two percentage point increase in the target for the federal funds rate, which ended the year at 4.25 percent. Up to its meeting in November, the Federal Reserve reiterated its intention to continue its policy of gradually withdrawing monetary stimulus. In its December meeting, the Federal Open Market Committee hinted that the process of raising the federal funds rate would probably come to an end shortly.

### III. Developments in the Mexican Economy: General Overview

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#### III.1. Economic Activity

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Economic growth was unbalanced among the economic sectors in 2005. The services sector expanded significantly, the agricultural sector decreased and recorded high volatility, while the industrial sector exhibited a modest performance, particularly in its manufacturing production component. Nonetheless, some industrial activities, including the automotive industry, recorded improvements in annual terms at the end of the year.

Economic activity fluctuated throughout 2005. GDP reduced significantly its rate of growth during the first semester of the year, compared with growth recorded during the second half of 2004, mainly in response to a decrease in external demand. Nonetheless, seasonally adjusted quarterly figures for GDP recorded significant growth during the second half of 2005 as economic activity benefited from improved exports.

As for aggregate demand, private consumption expenditure continued to make the highest contribution to real GDP growth, followed by gross capital formation, while the net trade balance of goods and services made a negative contribution. Consumption, measured at constant prices, was higher than in 2004. Meanwhile, investment grew slightly more than during the previous year, although there was a noteworthy increase in private sector investment during the last quarter of 2005.

In 2005, the performance of the Mexican economy was mainly characterized by the following aspects:

- a) Aggregate demand and GDP grew at a lower rate than in 2004.
- b) The strength of consumption expenditure stemmed from several factors, among which were: the greater availability of financing, job creation, the increase in real average earnings in different sectors and a significant amount of external resources from workers' remittances.
- c) Investment outpaced economic growth for the second consecutive year.
- d) Total public expenditure remained at a level similar to that observed in 2004 due to a combination of a slight rise in consumption expenditure and reduced investment expenditure.
- e) Exports of goods and services grew at a slower rate during 2005, although they recovered during the last months of the year.
- f) At the end of the year, Banco de México's Business Confidence and Consumer Confidence Indexes exhibited upward corrections.

- g) GDP growth responded to expansion in the services and industrial sectors, while the agricultural sector declined for the first time in thirteen years.
- h) Similar to previous years, in 2005, economic growth was higher in the non-tradable than the tradable goods sector.
- i) Manufacturing output improved during the second half of the year mainly as a result of expansion in the automotive industry.

### **III.2. Employment, Earnings and Productivity**

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The expansion of economic activity in 2005 was reflected in an increase in the demand for labor, which contributed to an important improvement of different employment indicators. In this regard, the significant increase in formal employment in almost all states of Mexico and most sectors of economic activity deserves mention.

The most relevant aspects of the labor market during the year were the following:

- a) A significant increase in the number of workers insured by the IMSS, which led to increasing annual percentage variations throughout the year.
- b) Formal employment growth was more evident in temporary jobs in urban areas than in permanent jobs.
- c) Job creation included practically all states.
- d) The increase in the number of workers insured by the IMSS was highest in the services and construction sectors, while in the manufacturing industry it exhibited more moderate growth.
- e) INEGI's monthly surveys of manufacturing employment reveal a significant recovery of employment in the maquiladora industry. Nonetheless, its level exhibited a significant decline as compared with its maximum historic level in 2000.
- f) The improvement of formal employment in 2005 did not translate into a shortage of skilled labor.
- g) The national open unemployment rate decreased during the year.

Some of the most important aspects regarding earnings and unit labor costs during 2005 were:

- a) The main indicators for earnings exhibited mixed growth. In particular, in the manufacturing industry the IMSS average reference wage and real average wages (based on INEGI's monthly survey) rose at a lower rate than in 2004, while average contractual wage increases rebounded.
- b) Unit labor costs (ULC) in the non-maquiladora manufacturing industry and retail trade sector fell at a lower rate than during the previous year. ULC in the maquiladora industry increased during 2005 after having contracted in 2004. This behavior is mainly explained by reduced labor productivity growth.

### III.3. External Sector

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During 2005, Mexico's external sector performance was characterized by the following: weak external demand; the significant rise in international crude oil prices; the loss of competitiveness of Mexican products in international markets; weaker domestic output, reflected in the demand for imports; and, significant and increasing inflow of workers' remittances. It is important to mention that after deducting the higher surplus of the oil trade balance and the increased inflow of workers' remittances from the trade balance and current account, these deficits widened significantly, consistent with the higher growth of domestic expenditure observed during the year as compared with that of GDP.

In 2005, the external sector was characterized by the following aspects:

- a) Lower growth of non-oil exports than during 2004 due to the slowdown of external demand and the persistent loss of competitiveness of Mexican products in external markets. The latter was partly a result of the lack of advances in implementing pending structural reforms.
- b) Significant increase in the value of oil exports in response to considerably higher crude oil prices in international markets, which contributed to a reduction in the trade balance deficit compared with 2004.
- c) Lower annual growth of merchandise imports with respect to that observed in 2004. This result responded to a reduction in production for the domestic market and a decrease in manufactured exports that use imported inputs for their production.
- d) Unfavorable performance of Mexican products in the U.S. market for the third year in a row. Mexico's exports to the U.S. grew less vigorously than total exports of the rest of U.S. trading partners. As a result, the share of Mexican products in U.S. imports decreased.
- e) Higher inflow of resources from workers' remittances.
- f) Reduction in the current account deficit of the balance of payments, measured in both US dollars and in relation to GDP. As in 2004, such deficit was mainly covered with long-term financial resources.
- g) Capital account surplus mainly due to inflows from foreign investment (both direct and portfolio) as well as external financing channeled to the non-bank private sector and financed investment projects known as PIDIREGAS.
- h) Significant inflow of financial resources from Foreign Direct Investment (FDI), very similar to levels observed in 2004.
- i) Public and commercial bank foreign indebtedness. There were also outflows of resources associated with an increase of Mexican residents' assets abroad.
- j) Significant increase in net international reserves.

### **III.4. Public Finances**

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During 2005, the public sector's economic deficit amounted to 7.5 thousand million pesos, equal to 0.09 percent of GDP. Excluding outlays from the Retirement Program for Public Employees (*Programa de Conclusión de la Relación Laboral*, CRL), such deficit totaled 3.1 thousand million pesos (0.04 percent of GDP). The primary surplus, defined as revenues less expenditures other than financial costs, was 207.4 thousand million pesos (2.48 percent of GDP).

In 2005, budgetary revenues totaled 1,948.2 thousand million pesos (23.26 percent of GDP), 167.2 thousand million above federal budget figures. This surplus was mainly due to: a) higher oil revenues (which equaled 1.3 percent of GDP and 65.3 percent excess revenues); b) an increase in revenues from public enterprises and institutions other than PEMEX, mainly from the Federal Electricity Commission (Comisión Federal de Electricidad, CFE) and the Public Employees' Social Security Institute (Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado, ISSSTE), which accounted for 19 percent of excess revenues; and, c) higher non-oil nontax revenues (mainly from duties and benefits). In 2005, budgetary expenditures totaled 1,953.7 thousand million pesos. This result represented an annual increase of 4.8 percent at constant prices and accounted for 23.33 percentage points of GDP (23.23 percentage points in 2004).

### **III.5. Monetary and Credit Aggregates**

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The monetary aggregate M1 grew at a lower rate throughout 2005, recording an annual average variation of 11.3 percent, below that observed in 2004 (13.9 percent). The slower growth rate of the narrow monetary aggregate was mirrored by all its main components. In contrast, during the reference period, the expansion of the broad monetary aggregates strengthened. The monetary aggregate M4, which measures financial savings in domestic instruments, recorded an annual real variation of 10.4 percent, 2.9 percentage points above the growth rate recorded in 2004 (7.5 percent at an annual real rate). M4 recovered significantly during the second half of 2005, registering real annual growth of 12.3 percent compared with 8.3 percent during the first half of the year.

The greater availability of financial resources has been accompanied by an important change in its final uses. In particular, the decline in public sector borrowing requirements and the slower pace of reserve accumulation by Banco de México have increased the availability of financial resources for the private sector. Thus, while in 2003, the increase in total financing to the private sector accounted for only 1.9 percent of GDP, in 2004 and 2005 it rose to 2.0 and 2.4 percent of GDP, respectively.

Thus, after a prolonged process of financial repression, access to domestic financing has gradually improved. Regarding the availability of resources for the private sector, two trends should be highlighted: a) greater availability of both consumer and mortgage credit to households; and, b) relative stagnation of total financing to firms. In 2005, total financing to households expanded at a real annual rate of 14.4 percent, with an accumulated annual flow accounting for 79.5 percent of total financing to the private sector. However, mortgage and

consumption credit remain at low levels as compared with GDP, reaching stocks of 8.7 and 3.7 percent of GDP in December 2005, respectively.

Total financing to firms remained weak, accounting for 15.4 percent of GDP at the end of 2005. This result reflects the effort to reduce firms' past-due loan portfolios. In particular, the trade and services component has increased its participation and at the end of 2005 represented 48.6 percent of total financing granted to firms. Furthermore, the amount of total credit denominated in foreign currency (including foreign credit) has declined.

### **III.6. Inflation**

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During 2005, inflation reflected mainly reflected the effect of two factors: first, the reversion of multiple supply shocks that affected the economy during 2004 and, second the monetary policy actions undertaken. These actions were geared towards both preventing the referred shocks from contaminating the price determination process. Annual headline inflation exhibited a converging trajectory with the 3 percent target and, starting August, it remained within the variability interval of plus/minus one percentage point determined around the target. In December, the referred indicator was 3.33 percent, 1.86 percentage points below the level recorded during the same month of the previous year. Headline inflation was influenced by both its core and non-core components, although the latter decreased more significantly.

Core inflation fell significantly, reaching at the end of the year an annual variation of 3.12 percent, 0.68 percentage points below the figure observed in December 2004. The declining trend of core inflation was mainly influenced by the slower growth rates of processed food prices and housing-services prices.

The decline of annual non-core inflation between December 2005 and December 2004 (from 8.20 to 3.76 percent), was due to the following: i) a drop in the annual inflation of prices of agricultural products; ii) a relatively contained pass-through of the surge in international oil prices to its domestic counterparts and; iii) a reduced increase in regulated prices of goods and services.

## IV. Monetary and Exchange Rate Policy

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### IV.1. Monetary Policy

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The number and magnitude of supply shocks during 2004 induced a considerable increase in inflation expectations for all terms. In the surveys conducted by Banco de México, expectations for annual inflation for the end of 2006 rose from 3.65 percent in May 2004 to 4.09 percent in December of that year. As a result the Board of Governors of Banco de México tightened the monetary policy stance in 2004 and the first half of 2005 in order to contain the increase in inflation expectations and avoid that these contaminate the price determination process.

During the first quarter of 2005, Banco de México tightened the monetary policy stance further, thus continuing the process that it had begun in 2004 through two channels: i) by increasing the corto (short position) from 69 million pesos in December 2004 to 79 million in March 2005; and ii) by stating in its press releases on monetary policy that until deemed convenient, domestic monetary conditions should mirror, at least, the greater monetary stringency prevailing in the U.S.

Later, in its press release of April 22, the Board of Governors of Banco de México announced its intention to maintain the corto unchanged and, since the press release of June 24, it stopped making reference to item ii) of the above paragraph. Nonetheless, in the latter it stated that, as deemed necessary, domestic monetary conditions should not loosen. As a result of these actions, the one-day banking funding rate rose from 8.75 percent on December 31, 2004 to 9.75 percent at the end of June, remaining at that level until August 25, 2005.

The inflationary pressures that affected the prices of different raw materials during 2004 dissipated throughout 2005, especially in the second half of the year. Furthermore, the supply conditions of several agricultural products, which were affected by adverse weather conditions in 2004, began to stabilize. This context combined with the monetary policy actions adopted in Mexico, led to significant reductions in headline and core inflation. In August, headline inflation was 3.95 percent and core inflation was 3.28 percent, while at the end of 2005 such indicators were 3.33 and 3.12 percent, respectively.

Thus, the abovementioned supply shocks did not have a significant effect on wage negotiations or, on the general price determination process in Mexico. As a result, inflation expectations for headline inflation for 2006 and 2007 were revised downward. Furthermore, at the end of 2005, forecasts included in Banco de México's survey for headline inflation for the end of 2006 were around 3.6 percent, figure similar to that observed before the supply shocks that arose in 2004.

In general, international financial markets remained slackened during 2005. As a result, sovereign spreads for some emerging economies recorded historically low levels in the last quarter of the year. After taking these favorable conditions and the slight improvements in the path of inflation and its expectations

into consideration, at the end of August, the Board of Governors of Banco de México began to reduce monetary restrictions. In its press releases of August, September, October and November, Banco de México allowed a loosening of monetary conditions of no more than 25 basis points on each occasion and no higher than 50 basis points in December. As a result, the one-day bank funding rate fell from 9.75 percent at the end of August to 8.25 percent at the end of 2005.

On another front, the yield curve in Mexico has been clearly influenced by global liquidity conditions and the consequent appetite for risk prevailing in international financial markets. Thus, numerous foreign investors searched in the domestic markets of many emerging economies for alternatives to increase the yield of their portfolios. In Mexico this has led to an increase in capital inflows to purchase longer-term debt instruments in domestic currency. This is also evidence that Banco de México's monetary policy actions have contributed to this result by reducing inflation expectations and the risk premia that is usually discounted from fixed rate instruments. Thus, during the second half of 2005, Mexico's yield curve flattened significantly. Furthermore, the convergence of the aforementioned led to a considerable reduction in interest rate spreads between Mexico and the U.S.

## **IV.2. Exchange Rate Policy**

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In March 2003, the Foreign Exchange Commission announced the implementation of a mechanism to reduce Banco de México's rate of accumulation of international reserves. In 2004 the Commission decided to adequate the mechanism in order to procure a more stable amount of daily US dollar sales. As mentioned in previous reports, the commission achieved the aforementioned by modifying the schedule of US dollar sales, while keeping the total amount of US dollars to be auctioned unchanged. Thus, starting in the quarter May-July of 2004, the amount of US dollars to be auctioned will continue to be 50 percent of the accumulated net reserves from the preceding quarter, after deducting total sales in that period. This amount will be auctioned in equal parts during the following four quarters.

2003 was a year in which the geopolitical uncertainty associated with the war in Iraq reduced investors' appetite for risk and contributed to a depreciation of the peso vis-à-vis the US dollar. During 2004 and 2005, however, favorable conditions prevailed in international markets due to relatively loose monetary conditions and reduced global geopolitical uncertainty. This environment led to a search for higher returns in international financial markets and to a higher appetite for risk among investors, particularly in emerging economies. As a result, the exchange rate of the Mexican peso against the US dollar remained relatively stable.

The significant rise in international prices of several raw materials throughout 2004 and 2005 contributed to an appreciation of the currencies of many emerging economies which mostly export raw materials. Such was the case of Chile, Brazil and Colombia. However, the Mexican peso remained more stable due to the fact that Mexico exports mainly manufactured goods.

## V. Final Remarks

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Despite further increases in crude oil prices and the gradual tightening of restrictive monetary policy in the U.S., the world economy expanded significantly during 2005, while inflation remained at modest levels. Although economic activity in the U.S. declined, growth in Asia remained solid due to the strength of the Chinese economy and economic recovery in Japan. International financial markets absorbed the increases in short-term interest rates in an orderly fashion and sovereign spreads for some emerging economies recorded historically low levels as such countries benefited from extremely favorable external financial conditions.

The Mexican economy grew 3 percent in 2005, although growth was unbalanced among the economic sectors. The services sector expanded significantly, the agricultural sector recorded high volatility, while the performance of the industrial sector was modest, particularly of its manufacturing production component. Nonetheless, some industrial activities, like the automotive industry, recorded an improvement in annual terms during the fourth quarter of the year.

Medium-term inflation expectations rose considerably as a result of the number and intensity of supply shocks which occurred in 2004. Under this environment, the Board of Governors of Banco de México tightened its monetary policy stance throughout 2004 and in the first half of 2005 in order to contain upward pressure on inflation expectations and prevent them from contaminating the price determination process.

Throughout 2005, particularly in the second half of the year, inflationary pressures associated with increases in international prices of different raw materials began to dissipate. The convergence of the aforementioned with the effects of the monetary policy actions adopted led to significant reductions in headline and core inflation. Thus, in 2005 annual headline inflation adopted a path convergent with the 3 percent target and, since August, it remained within the variability interval of plus/minus one percentage point established around the target. In December, annual inflation was 3.33 percent, implying a reduction of 1.86 percentage points from its level in December 2004. This result responded to the behavior of both its core and non-core components.

The favorable external environment and the improvement in the path of inflation and its expectations allowed the Board of Governors of Banco de México to revert, since August 2005, its stance of monetary astringency. As a result, the one-day bank funding interest rate fell from 9.75 percent at the end of August to 8.25 percent at the end of 2005.

A less restrictive monetary policy is congruent with the reduction of inflation and its expectations. Nonetheless, although significant improvements have been observed regarding inflation abatement, inflation expectations are still above the 3 percent target set by Banco de México. Under this context, monetary policy will continue to focus on fostering the convergence of inflation to its target.

It is important to reiterate that stability is a necessary but not the only condition to attain sustained growth. Progress towards a greater stability of the Mexican economy has had a significant influence through its effect on aggregate demand, allowing consumption and investment to expand and become more

stable throughout the years. Nonetheless, the current challenge is to implement structural changes destined to increase the flexibility of the economy's productive structure and, hence, to raise its growth potential. Under this context, the need to advance in the pending agenda of structural changes in Mexico is evident. As broad consensuses regarding structural reforms with a long-term vision are attained, the lag in competitiveness that the Mexican economy has accumulated in recent years with respect to other economies might be reverted, therefore laying sounder foundations for the country's future growth.